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Active vs. Passive Portfolio Management

Proponents of active portfolio management believe that a skilled investment manager can generate returns that outperform a benchmark index. Advocates of passive investing argue that the best way to capture overall market returns is to use low-cost index-based investments.

One of the longest-standing debates in investing is over the relative merits of active portfolio management versus passive management. With an actively managed portfolio, a manager tries to beat the performance of a given benchmark index by using his or her judgment in selecting individual securities and deciding when to buy and sell them. A passively managed portfolio attempts to match that benchmark performance, and in the process, minimize expenses that can reduce an investor's net return.

Each camp has strong advocates who argue that the advantages of its approach outweigh those for the opposite side.

Active investing: attempting to add value

Proponents of active management believe that by picking the right investments, taking advantage of market trends, and attempting to manage risk, a skilled investment manager can generate returns that outperform a benchmark index. For example, an active manager whose benchmark is the Standard & Poor's 500 Index (S&P 500) might attempt to earn better-than-market returns by overweighting certain industries or individual securities, allocating more to those sectors than the index does. Or a manager might try to control a portfolio's overall risk by temporarily increasing the percentage devoted to more conservative investments, such as cash alternatives.

An actively managed individual portfolio also permits its manager to take tax considerations into account. For example, a separately managed account can harvest capital losses to offset any capital gains realized by its owner, or time a sale to minimize any capital gains. An actively managed mutual fund can do the same on behalf of its collective shareholders.

However, an actively managed mutual fund's investment objective will put some limits on its manager's flexibility; for example, a fund may be required to maintain a certain percentage of its assets in a particular type of security. A fund's prospectus will outline any such provisions, and you should read it before investing.

Passive investing: focusing on costs

Advocates of unmanaged, passive investing — sometimes referred to as indexing — have long argued that the best way to capture overall market returns is to use low-cost market-tracking index investments. This approach is based on the concept of the efficient market, which states that because all investors have access to all the necessary information about a company and its securities, it's difficult if not impossible to gain an advantage over any other investor. As new information becomes available, market prices adjust in response to reflect a security's true value. That market efficiency, proponents say, means that reducing investment costs is the key to improving net returns.

Indexing does create certain cost efficiencies. Because the investment simply reflects an index, no research is required for securities selection. Also, because trading is relatively infrequent — passively managed portfolios typically buy or sell securities only when the index itself changes — trading costs often are lower. Also, infrequent trading typically generates fewer capital gains distributions, which means relative tax efficiency.

Note: *Before investing in either an active or passive fund, carefully consider the investment objectives, risks, charges, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. And remember that indexing — investing in a security based on a certain index — is not the same thing as investing directly in an index, which cannot be done.*

Blending approaches with asset allocation

The core/satellite approach represents one way to employ both approaches. It is essentially an asset allocation model that seeks to resolve the debate

All investing involves risk, including the potential loss of capital, and there can be no guarantee that any investing strategy will be successful.

A portfolio invested only in companies in a particular industry or market sector may not be sufficiently diversified and could be subject to a significant level of volatility and risk.

about indexing versus active portfolio management. Instead of following one investment approach or the other, the core/satellite approach blends the two. The bulk, or "core," of your investment dollars are kept in cost-efficient passive investments designed to capture market returns by tracking a specific benchmark. The balance of the portfolio is then invested in a series of "satellite" investments, in many cases actively managed, which typically have the potential to boost returns and lower overall portfolio risk.

Note: *Bear in mind that no investment strategy can assure a profit or protect against losses.*

Controlling investment costs

Devoting a portion rather than the majority of your portfolio to actively managed investments can allow you to minimize investment costs that may reduce returns.

For example, consider a hypothetical $400,000 portfolio that is 100% invested in actively managed mutual funds with an average expense level of 1.5%, which results in annual expenses of $6,000. If 70% of the portfolio were invested instead in a low-cost index fund or ETF with an average expense level of 0.25%, annual expenses on that portion of the portfolio would run $700 per year. If a series of satellite investments with expense ratios of 2% were used for the remaining 30% of the portfolio, annual expenses on the satellites would be $2,400. Total annual fees for both core and satellites would total $3,100, producing savings of $2,900 per year. Reinvested in the portfolio, that amount could increase its potential long-term growth. (This hypothetical portfolio is intended only as an illustration of the math involved rather than the results of any specific investment, of course.)

Popular core investments often track broad benchmarks such as the S&P 500, the Russell 2000® Index, the NASDAQ 100, and various international and bond indices. Other popular core investments may track specific style or market-capitalization benchmarks in order to provide a value versus growth bias or a market capitalization tilt.

While core holdings generally are chosen for their low-cost ability to closely track a specific benchmark, satellites are generally selected for their potential to add value, either by enhancing returns or by reducing portfolio risk. Here, too, you have many options. Good candidates for satellite investments include less efficient asset classes where the potential for active management to add value is increased. That is especially true for asset classes whose returns are not closely correlated with the core or with other satellite investments. Since it's not uncommon for satellite investments to be more volatile than the core, it's important to always view them within the context of the overall portfolio.

Tactical vs. strategic asset allocation

The idea behind the core-and-satellite approach to investing is somewhat similar to practicing both tactical and strategic asset allocation.

Strategic asset allocation is essentially a long-term approach. It takes into account your financial goals, your time horizon, your risk tolerance, and the historic returns for various asset classes in determining how your portfolio should be diversified among multiple asset classes. That allocation may shift gradually as your goals, financial situation, and time frame change, and you may refine it from time to time. However, periodic rebalancing tends to keep it relatively stable in the short term.

Tactical asset allocation, by contrast, tends to be more opportunistic. It attempts to take advantage of shifting market conditions by increasing the level of investment in asset classes that are expected to outperform in the shorter term, or in those the manager believes will reduce risk. Tactical asset allocation tends to be more responsive to immediate market movements and anticipated trends.

Though either strategic or tactical asset allocation can be used with an entire portfolio, some money managers like to establish a strategic allocation for the core of a portfolio, and practice tactical asset allocation with a smaller percentage.

Note: *Asset allocation and diversification are methods used to help manage investment risk; they do not guarantee a profit or protect against investment loss.*

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